IN THE HIGH COURT OF JUDICATURE AT BOMBAY

O. O. C. J.

COMPANY APPEAL NO.1 OF 2007
IN
COMPANY PETITION NO.16/111/CLB/WR/2006

Mr. Sanjay Bathija. ...Appellant.

Versus

M/s.Prashant Properties & Investment Pvt. Ltd. & Ors. ...Respondents.

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Mr.D. J. Khambata, Senior Advocate with Mr. Paresh Shah & Ms. Jyoti Tanksale i/b. Shah & Sanghvi for the Appellant.
Mr. Cyrus E. Bharucha with Mr.Salian i/b. Gagrats for the Respondents.

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CORAM : DR. D.Y. CHANDRACHUD, J.

May 4, 2007.

ORAL JUDGMENT :

The Appellant is a shareholder with a holding of 170 shares in the issued and subscribed capital of the First Respondent. At the material time, the Third Respondent was also a shareholder with a holding of 10 shares. On 7th December 2001, the Directors of the First Respondent permitted the transfer of (i) 300 equity shares from the account of one Madan Mohan Bathija; (ii) 10 equity shares from

the account of Madan Mohan Bathija HUF ; and (iii) 10 equity shares from the account of the Fourth Respondent to the Third Respondent. Accordingly, the Third Respondent held 330 shares in the issued and subscribed share capital of the Company. On the same day, the Directors of the First Respondent permitted the issue and allotment of 4490 equity shares of the First Respondent to the Second Respondent. There is no dispute about the factual position that the Second Respondent was not a shareholder of the First Respondent prior to the aforesaid issue.

2. In September 2003, the Second Respondent informed the First Respondent of its desire to transfer 1497 shares out of the 4490 shares held by it in the First Respondent. The aforesaid shares were offered to the Appellant and ultimately in February 2006, 1490 shares were transferred to the Appellant.

3. The Appellant instituted a petition before the Company Law Board (CLB), in order to challenge (i) The transfer of 320 shares of the issued and subscribed capital of the First Respondent to the Third

Respondent; and (ii) The allotment of 4490 shares of the issued capital of the First Respondent to the Second Respondent. The challenge before the CLB was that the transfer/allotment was contrary to the Articles of Association of the First Respondent. The Appellant sought rectification of the Register.

4. The CLB by its order dated 22nd November 2006 held that: (i) The First Respondent had correctly transferred 320 shares to the Third Respondent; and (ii) The First Respondent had wrongly allotted 4490 shares to the Second Respondent. The CLB, therefore, directed the First Respondent to cancel the allotment of 4490 shares to the Second Respondent. Consequently, the subsequent transfer of 1490 shares out of the aforesaid 4490 shares to the Appellant was also cancelled. The Second Respondent was directed to refund an amount of Rs.1,49,000/- paid by the Appellant against the transfer of shares. The First Respondent has been permitted to allot the 4490 shares to existing shareholders in accordance with law.

5. In the course of the submissions urged on behalf of the

Appellant, the order of the CLB has been impugned under two heads of challenge. The first head of challenge deals with the allotment of 4490 shares. The submission before the Court is that the Company had addressed a letter to the Appellant recording that it had received an offer from existing shareholders for the sale of 1497 equity shares and stating that under Article 8 of the Articles of Association, it was mandatory for the Company to offer the shares to the existing shareholders. In pursuance of a letter addressed by the Company on 25th September 2003, the Appellant had addressed a reply dated 29th September 2003 accepting the offer. In the circumstances, it was urged that the Appellant had acquired a vested right to a certain proportion of shares with reference to his shareholding.

6. The second head of challenge relates to the transfer of 320 shares to the Third Respondent and the submission before the Court raises an issue as to the interpretation of Articles 22, 23 and 25 of the Articles of Association.

7. In so far as the first ground of challenge is concerned, Article 8 of the Articles of Association provides as follows :

> "Subject to any direction to the contrary that may be given by the resolution sanctioning the increase of share capital all new shares shall before issue, be offered to such persons who at the date of the offer are entitled to receive notice from the company of general meeting in proportion as nearly as the circumstances admit to the amount of the existing share to which they are entitled. The offer shall be made by notice specifying the number of shares offered and limiting a time within which the offer if not accepted, shall be deemed to have been declined and after the expiration of that time or on the receipt of an intimation from the persons to whom the offer is made that he declines to accept the shares offer, the Directors may dispose of the same in such manner as they think beneficial to the company. The Directors may likewise so dispose of any shares which are not capable of being offered without fraction, to the members in proportion to their holdings."

The CLB observed that a plain reading of Article 8 makes it clear that all new shares had to be offered to the existing shareholders of the Company. The aforesaid Article does not empower the Board to allot shares to outsiders on the date of the increase of the paid up capital. Prior to the allotment of 4490 shares to the Second Respondent on 2nd December 2001, the paid up capital of the Company was only Rs.51,000/-. In the present case the Company proceeded to allot a

majority of shares to the Second Respondent who was an outsider without offering the new shares to the existing shareholders, resulting in a violation of the provisions of Article 8. The allotment of 4490 new shares to the Second Respondent was consequently held to be illegal and void. That being the position, the Company was required to cancel 1490 shares transferred to the name of the Appellant out of 4490 shares which were illegally allotted to the Second Respondent. However, the Company was granted liberty to allot the 4490 shares to the existing shareholders in accordance with law.

8. The view formed by the CLB on this aspect of the matter is unexceptionable. The allotment of the 4490 new shares to the Second Respondent who is an outsider was plainly contrary to the mandate of Article 8 of the Articles of Association. The allotment was manifestly illegal and void. The allotment of 4490 shares to the Second Respondent being void, the transfer of 1497 shares to the Appellant was, as a matter of consequential relief, also liable to be quashed and set aside, the aforesaid shares being part of 4490 shares which were allotted to the Second Respondent illegally. The

order of the CLB permits the allotment of shares afresh in accordance with the provisions of law. The direction in this regard cannot be faulted.

9. The second head of challenge relates to the transfer of 320 shares to the Third Respondent. Article 22 of the Articles of Association provides as follows :

> "22. Save as herein otherwise provided no share shall be transferred to any person who is not a member of the company or a member of the family of the member so long as any member or any person selected by the Board as the one desirable in the interest of the company to admit to membership is willing to purchase the same at the fair value to be determined in the manner hereinafter provided.
>
> Member of the family of a member shall mean any child or other legal issue, father, mother, brother, sister, sons, wife, daughters, husband, sons son or daughter, daughters son or daughter, wife or husband of such member."

Article 23 of the Articles provides as follows :

> "23. Except where the transfer is made pursuant to regulation 22 the person proposing to transfer any share (hereinafter called the proposing transferor) shall give notice in writing (hereinafter called the 'transfer notice') to the company that he desires to transfer the same. Such notice shall specify the denoting number of the share and the sum he fixes as the fair value, and shall constitute the

> Board his agent for the sale of the share to any member or person selected as aforesaid willing to purchase the share (hereinafter called the “purchasing member”) at the price so fixed or at the option of the Board at the fair value to be fixed as hereinafter provided.
>
> A transfer notice may include several shares and in such case shall operate as if it were a separate notice in respect of each.”

Article 24 provides thus :

> “In case the Board agrees with the value of share fixed by the proposing transferor the share shall be offered to the members at that value. In case the Board does not agree with proposed transferor as the fair value of the share, the Auditors of the company shall on the application of either party, certify in writing the sum which in their opinion, is the fair value, and in so certifying the auditors shall be considered to be as an expert and not as arbitrator.”

Article 25 inter alia provides that the shares specified in any transfer notice shall be offered by the Directors in the first place to members other than the proposing transferor as nearly as may be in proportion to the existing shares held by them respectively.

10. The contention of the Appellant is that Article 23 applies to all categories of shares transferred, that is, even to a transfer inter

se among members, the only exception being a transfer pursuant to Article 22. Hence, the submission is that the transfer of 320 shares of the First Respondent was required to be governed by Article 23 and since the First Respondent had not followed the procedure laid down in Article 23, the transfer of the said shares to the Third Respondent must be declared as illegal.

11. Article 22 of the Articles of Association lays down that save as herein otherwise provided, no share shall be transferred to any person who is not a member of the Company or a member of the family of the member, so long as any member or any person selected by the Board as the one desirable in the interest of the company is willing to purchase the shares at a fair value to be determined. The primacy that is given by Article 22 is to existing members of the Company and to a member belonging to the family of an existing member. Save and except where a transfer is made to a person falling in the aforesaid category, shares cannot be transferred to any person, so long as a person selected by the Board as being desirable in the interest of the Company is willing to purchase at the price fixed

or, as the case may be, the fair market value. Article 23 begins with the words “Except where the transfer is made pursuant to regulation 22”. In all other cases, the transferor has to furnish a notice to the Company of his desire to transfer the shares. The notice has to specify the number of shares, the sum fixed as fair value and has to constitute the Board as an agent for the sale of the shares to any member or a person selected as aforesaid willing to purchase the shares at the price so fixed or at the option of the Board at the fair value to be fixed. Article 24 deals with the modalities of determining the fair value and Article 25 provides for the offering of the shares to members other than the proposing transferor in proportion to their existing share capital.

12. The Articles of Association contemplate distinct and separate modes of transfer of the shares of the Company. Article 22 is couched in the negative and embodies a prohibition. It prohibits a transfer to a person so long as a member or person selected by the Board as being in the interest of the company is willing to purchase the shares at a fair value to be determined. The mode of

determination of the fair value, as Article 22 states, is “hereinafter provided”. Article 24 provides the modality of determining fair value. Article 23 prescribes the procedure for a member who desires to transfer shares – the procedure being a notice constituting the Board as an agent to transfer the shares to any member or “person selected as aforesaid”. “Person selected as aforesaid” is a person as set out in Article 22 as one whom the Board considers in the interests of the Company. Article 23 contains an exception to its applicability. The exception is where the transfer is made pursuant to regulation 22. It Article 23 were held to apply to all transfers, as the appellant submits, the words “except where the transfer is made pursuant to regulation 22” will be rendered otiose. A construction which renders a part of the instrument otiose must be eschewed and a harmonious construction which will give a field of operation for all provisions must be preferred. The submission urged on behalf of the Appellant would render the opening words of Article 22 redundant. Article 5 of the Articles of Association provides that the shares shall be under the control of the Directors who may allot or otherwise dispose of the same to such persons, on such terms and at such time, as the

Directors think fit and may give to any person any share either at par or at premium and for such consideration as the Directors may think fit. The interpretation of the Articles must, therefore be such as would place a harmonious construction on all the provisions contained therein including inter alia Articles 5, 22 and 23. An interpretation which seeks to render one part of the Articles otiose must be avoided. Undoubtedly, as held by the Supreme Court in **Dale & Carrington Invt. (P) Ltd. vs. P.K. Prathapan**,[1] even though Section 81 of the Companies' Act, 1956 does not apply to a Private Limited Company, the Directors are obliged to act in good faith and to make a full disclosure to the shareholders regarding the affairs of the Company. The acts of the Directors in a Private Limited Company are required to be tested "on a much finer scale" in order to rule out any misuse of powers for any personal gain or ulterior motive. The Supreme Court held thus:

> "Private limited companies are normally closely held i.e. the share capital is held within members of a family or within a close-knit group of friends. This brings in considerations akin to those applied in cases of partnership where the partners owe a duty to act with utmost good faith towards each other. Non-applicability of Section 81 of the Act to private companies does not mean that the Directors have

1 (2005) 1 SCC 212

> absolute freedom in the matter of management of affairs of the company."

Articles 23 and 25 would, therefore, apply to a situation where the transferor does not want to transfer his shares only to a particular member of the Company or a member of his family in which case, the transferor gives notice to the Board of Directors and appoints the Board as his agent. The Board of Directors thereupon acting as the agent of the transferor would offer the shares to the existing shareholders in proportion to their share holding.

13. In the present case, the transferors, namely, (i) Madan Mohan Bathija, who holds 300 shares; (ii) Madan Mohan Bathija HUF holding 10 shares; and (iii) the Fourth Respondent holding 10 shares had decided to transfer shares to the Third Respondent. The Third Respondent was an existing shareholder of the Company and the Board of Directors approved the Third Respondent as transferee. The transfer, therefore, fell within the purview of Article 22 and is approved by the Board. Being a transfer governed by Article 22, the provisions of Articles 23 onwards had no application. The transfer of

320 shares to the Third Respondent was, therefore, valid and was correctly upheld by the CLB.

14. The CLB was for the aforesaid reasons justified in holding that the allotment of 4490 shares to the Second Respondent was void, consequent upon which the transfer of 1497 shares therefrom to the Appellant would have to be cancelled. The Company was correctly permitted to allot the 4490 new shares in accordance with law. As far as the 320 shares are concerned, the CLB was justified in coming to the conclusion that since the existing shareholders sold the shares directly to the Third Respondent who was a shareholder and the Company and the Board had approved the transfer, Article 23 had no application and the Company has rightly transferred those shares to the Third Respondent.

15. The appeal is lacking in merit and shall accordingly stand dismissed.

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